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Chain Deficit Rule Technical Assistance

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You have asked us informally to consider the subpart F consequences of a [REDACTED] distribution of previously taxed income by a lower-tier controlled foreign corporation (a "CFC") to an upper-tier CFC. The taxpayer in this case argues that the distribution should not increase the earnings and profits of the upper-tier CFC for purposes of the application of the chain deficit rule. As discussed below, however, the applicable rules require that the taxpayer increase the earnings and profits of the upper-tier CFC by the amount received in the distribution from the lower-tier CFC.

FACTS

[REDACTED], a domestic corporation, is a wholly-owned subsidiary of [REDACTED], which is also a domestic corporation. [REDACTED] has a wholly-owned Swiss subsidiary, [REDACTED], which in turn has a wholly owned Bermuda subsidiary, [REDACTED]. [REDACTED] also has other wholly-owned foreign subsidiaries, some of which have deficits in earnings and profits for [REDACTED].

In its taxable year [REDACTED] made a distribution of \$[REDACTED] to [REDACTED]. The distribution included \$[REDACTED] attributable to earnings and profits of [REDACTED] reported as subpart F income by [REDACTED] in [REDACTED]. The balance of the distribution was attributable to earnings and profits reported by [REDACTED] as subpart F income in prior years. [REDACTED]

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increased its basis in the stock of [REDACTED] by the \$ [REDACTED] it reported as subpart F income. In addition, [REDACTED] reduced its basis in the stock of [REDACTED] by the amount of the distribution it received from [REDACTED] in [REDACTED].

DISCUSSION

At issue in this case is whether [REDACTED] is required to increase its earnings and profits by the amount received in the distribution from [REDACTED] for purposes of the application of the chain deficit rule. The distribution includes earnings and profits of [REDACTED] attributable to amounts included in the income of [REDACTED] under section 951 of the Internal Revenue Code.¹ Taxpayer argues that no earnings and profits adjustment is required, pursuant to section 312(f), because [REDACTED] reduced its basis in the stock of [REDACTED] by the amount of the distribution. If [REDACTED] is required to increase its earnings and profits by the amount of the distribution, taxpayer contends that for purposes of the chain deficit rule those earnings and profits will be taxed twice because the positive earnings and profits will be offset by deficits in earnings and profits allocable to [REDACTED] from its foreign subsidiaries other than [REDACTED] pursuant to the chain-deficit rule of section 952(d) and section 1.952-1(d) of the regulations. The taxpayer also argues that Rev. Rul. 86-33, 1986-1 C.B. 287, is distinguishable from this case because section 312(f)(2) applies.

In general, a U.S. shareholder of a controlled foreign corporation (a "CFC") is required to include currently in its gross income certain items of income of the CFC, determined pursuant to subpart F of the Code.² The U.S. shareholder is not taxed on such income a second time, however, when the earnings

¹ All section references are to the Internal Revenue Code of 1954, in effect for the taxable years at issue in this case.

² A United States shareholder, defined in section 951(b), is a U.S. person that owns 10 percent or more of the combined voting power of all classes of stock of the foreign corporation that are entitled to vote. [REDACTED], which owns all of the stock of [REDACTED], is thus a U.S. shareholder of that corporation.

A CFC is a foreign corporation more than 50 percent of the voting power of whose stock is owned, within the meaning of section 958, by United States shareholders. See section 957. Section 958, which describes certain rules of attribution and constructive ownership, provides that a lower-tier foreign corporation wholly owned by an upper-tier foreign corporation that is a CFC is itself a CFC. Therefore, both [REDACTED] and [REDACTED] are CFCs within the meaning of section 957.

and profits of the CFC are actually distributed. Thus, an amount received by a U.S. shareholder in a distribution of earnings and profits of the CFC that is attributable to amounts previously included in the shareholder's gross income under subpart F (referred to herein as "PTI"), is excluded from the gross income of the U.S. shareholder pursuant to section 959(a) of the Code.

Section 959 of the Code excludes from the gross income of a U.S. shareholder PTI that is distributed not only directly, but also indirectly through a chain of ownership, to the U.S. shareholder. In addition, section 959 excludes from the gross income of a CFC PTI that is received in a distribution from a lower-tier CFC. Section 1.959-2(a) of the regulations. This exclusion applies only for purposes of determining the income of the CFC that must be currently included in the gross income of the U.S. shareholder under subpart F. The provision does not affect the calculation of the earnings and profits of the recipient CFC. Rev. Rul. 86-33; and section 1.959-2(b) of the regulations.

Section 961 of the Code requires a U.S. shareholder to make certain adjustments to its basis in the stock of the CFC to reflect amounts included or excluded from the gross income of the U.S. shareholder pursuant to subpart F.³ Like section 959, section 961 is intended in part to ensure that the U.S. shareholder is not taxed twice on income attributable to the same item of income of the CFC. Section 961(a) thus provides that a U.S. shareholder of a CFC must increase his basis in the stock of the CFC by the amount that he includes in his gross income under section 951(a). A U.S. shareholder that receives a distribution of PTI must reduce his basis in the stock of the CFC by the amount excluded from gross income pursuant to section 959(a). Section 961(b).

Section 961 of the Code states clearly that the basis adjustments required apply only to the basis of a U.S. shareholder in the stock of a CFC, and not to the basis of a CFC in the stock of another CFC. Accordingly, it is appropriate for [REDACTED] to increase its basis in the stock of [REDACTED] by the amount reported as subpart F income for [REDACTED], \$[REDACTED]. [REDACTED] may not make any adjustment to its basis in the stock of [REDACTED] as a result of the distribution of PTI it received from [REDACTED], however, since [REDACTED] is not a U.S. shareholder.

Section 312(f)(2) of the Code provides that a shareholder shall not increase its earnings and profits as a result of the receipt of a tax-free distribution in respect of its stock, if

³ The rules of section 961 of the Code are analogous to those governing the adjustments to a partner's basis in its partnership interest under subchapter K of the Code.

the amount of the distribution is applied to reduce the basis of the stock, or if the basis of the stock is allocated between the stock and the property received in the distribution. The distribution may be applied to reduce the shareholder's basis in its stock only under the law applicable to the year the distribution is made. Section 1.312-8(a) of the regulations. Because section 961 does not permit [REDACTED] to reduce its basis in the stock of [REDACTED] for U.S. tax purposes as a result of the distribution from [REDACTED], section 312(f)(2) does not apply. Thus, the distribution will increase [REDACTED]' earnings and profits.

You have also asked whether the result reached in this case is equitable, since its effect is to use deficits that might otherwise reduce subpart F income under the chain deficit rule. Taxpayer argues that this result effectively taxes the same income twice, first by taxing the income earned by [REDACTED] as subpart F income, and then by including the distribution attributable to such income to increase earnings and profits, which absorb deficits from other CFCs in the chain.

It is inaccurate to contend that the PTI distributed by [REDACTED] to [REDACTED] is taxed twice, since the distribution itself will not produce subpart F income by reason of the operation of section 959. Its effect on the subpart F inclusion of the U.S. shareholder would only be indirect, since it would be applied only for purposes of the chain deficit rule of section 952(d) and the regulations thereunder. Because of the inclusion of the distribution from [REDACTED] in the earnings and profits of [REDACTED], [REDACTED] may not be able to receive as great a benefit from the use of its subsidiaries' deficits. However, in this case, [REDACTED] will never have to include in income under section 951 an amount that is greater than what it otherwise would have to include if the subsidiaries did not have a deficit in earnings and profit. Accordingly, the result obtained is not inequitable.